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One of the areas of the Internal Revenue Code which is substantially changed by the Tax Reform Act of 1969 is Section 170 which provides for deductions for charitable contributions. For conscientious tax planners the new provisions will require some in-depth study during 1970. The House Ways and Means Committee reviewed carefully the tax returns of a few wealthy persons who were paying little or no tax and found that Section 170 offered a primary opportunity for the avoidance of tax. In order to correct this situation, the amendments eliminate the unlimited charitable contribution deduction and cut down drastically on the availability of deductions for the full fair market value of donated property which has appreciated in value.

Unlimited Charitable Deduction

Under the prior law an unlimited charitable deduction was allowed in certain circumstances. In order to qualify, the taxpayer's charitable deductions for the past eight out of ten taxable years, plus his income taxes, must have exceeded over 90 percent of his taxable income. The qualifying contributions must have been made to publicly supported organizations such as churches, schools, hospitals, and other organizations supported primarily from public and governmental sources. The new law (Sec. 170 (b) (1) (C)) eliminates this unlimited deduction for taxable years beginning after December 31, 1974. The deductions allowed during the five-year phase out are gradually reduced down to a maximum deduction of 50 percent of the taxpayer's adjusted gross income.

Fifty Percent Maximum Deduction

All taxpayers will be allowed a maximum 50 percent deduction for charitable contributions under the new provisions in lieu of the 30 percent maximum deduction which has been previously available. The new 50 percent rule applies to gifts to public charities (churches, schools, etc.), and also applies to donations to the following types of private charities which were not included under the old 30 percent rule:

(1) A private operating foundation.
(2) A private nonoperating foundation which distributes all contributions received to public charities within 2½ months after each year end, and
(3) A community foundation.

This requires a few definitions. A private operating foundation is one which spends its income directly for the charitable purposes for which it was organized. This is defined under the new provisions relating to private foundations in new Section 4942(j)(3). The House Committee Report indicated that a private operating foundation must spend at least 85 percent of its income directly for its charitable purpose. Additional requirements are that over half (the House suggests 65 percent) of the foundation's assets must be devoted to its charitable activities, or the foundation's support must come from at least five independent exempt organizations or from the public, or the foundation must have an endowment which provides sufficient income to cover two-thirds of current operating expenses. If you just got lost, do not despair—so did the writer. Number one, there is an income requirement, and number two, there is one of three other alternative requirements, one relating to use of assets, one relating to support, and one relating to endowment to cover expenses. The reason for this complicated set of requirements was to bring within the public charity rules some special organizations which operate for the benefit of the public, but were originally established as private foundations, and, in addition, include within their activities income-producing operations. Examples are included in the House and Senate Committee reports—Callaway Gardens, a horticultural and recreational area for public use; Colonial Williamsburg, which includes facilities for the public; and Jackson Hole, where businesses related to the public parks are operated. These three organizations meet both the income and asset tests. The definition of a private operating foundation is much more important in determining those foundations which will be subject to sanctions under the new laws relating to taxation of private foundations than it is in the present context. However, philanthropists will have some difficult decisions to make during 1970 if they wish to successfully protect their tax-motivated gifts.

A private nonoperating foundation is self-explanatory provided everything that is not a private foundation in the first place is adequately defined. So far, there has been little indication that this is possible. However, for the purposes of the 50 percent maximum deduction limitation, the average taxpayer can safely assume that any foundation which distributes everything it receives within 2½ months after the year end to organizations which are clearly publicly supported is safe. But the taxpayer better assure himself that the foundation is indeed distributing such receipts to organizations which cannot, under any circumstances, be defined as anything but a public charity.

A community foundation is one that pools its contributions into a common fund. A contributor can designate the charity which is to receive his contribution. The income from the common fund must be distributed within 2½ months after the taxable year in which it is realized. Please note that this is not a requirement that all the contributions received be so distributed, but only that the income earned by the common fund be distributed. A community foundation is not adequately defined in the Committee reports which accompany the Tax Reform Act. Other writers on the Tax Reform Act have rather glossed over it. A community foundation is described in Code Section 170(b)(1)(E)(iii), which refers to Code Section 509(a)(3). For those in the know, a contribution to such an organization does qualify for the 50 percent limitation.

Exceptions to the Fifty Percent Deduction

An important exception to the 50 percent ceiling is the treatment of donations of appreciated property which, if sold, would result in long-term capital gain. Deductions for this type of property donations cannot exceed 30 percent of the taxpayer's adjusted gross income unless the taxpayer elects to recognize the appreciation by reducing his deduction in the manner described below. This is a very complicated provision; without regulations, it is almost impossible to explain accurately. Section 170(b)(1)(D) provides that the total amount of contributions of such appreciated property which may be taken into account shall not exceed 30 percent of the taxpayer's contribution base (adjusted gross income before contributions). For purposes of this subsection, contributions of capital gain property "to which this paragraph applies shall be taken into account after all other charitable contributions." This seems to indicate that if any appreciated property is contributed, the 30 percent limitation shall apply to the taxpayer's entire contribution even though the appreciated property may be an immaterial portion of total contributions. This does not seem logical. But, it is conceivable that a taxpayer cannot use up his 30 percent limitation in appreciated property and still give cash donations of an additional 20 percent of his contribution base. He will therefore be required to plan carefully for cash and property contributions.

The other exception to the 50 percent rule applies to gifts to private foundations. These gifts are limited to 20 percent of the taxpayer's contribution base. Under the prior law taxpayers could contribute up to 20 percent of their contribution base to private foundations; if they contributed an additional 10 percent to public charities, a total 30 percent deduction was available. This appears to be the same under the 1969 law, except that an additional 30 percent can be given to public charities provided there is not appreciated property involved in the additional 30 percent. Unless, of course, the taxpayer wishes to take advantage of the election to limit his deduction with respect to appreciated property in order to get the 50 percent maximum. Other charities which do not qualify under the 50 percent maximum deduction rule are war veterans' and fraternal organizations.

Contributions of Appreciated Property

Prior law permitted a deduction with respect to charitable gifts of property equal to the fair market value of the property donated. The only exception to this rule was the requirement that the deduction be reduced by the amount of depreciation which would have been subject to the recapture rules of Sections 617, 1245, and/or 1250 in the event the property had been sold by the taxpayer. Under these provisions, the taxpayers in the higher brackets could realize a higher after-tax profit through the donation of property which, if sold, would give rise to ordinary income than if he sold the property and paid the income tax which would be assessed on the gains.

The Tax Reform Act limits substantially the benefits which have been available. In the first place, a contribution of property which, if sold, would result in ordinary income can be deducted only to the extent of the taxpayer's basis in the property under amended Section 170(e)(1)(A). This would include gifts of inventory items, capital assets which have been held for less than six months, and works of art, collections of papers, and other tangible personal property of this type which is still in the hands of the original creator or his heirs or assigns. If depreciable property is contributed and the sale of such property would have resulted in ordinary income due to the requirements of Sections 617, 1245, and 1250 to recapture excess depreciation, the charitable contribution deduction is limited to the fair market value of the property on the date of the gift reduced by the amount of such excess depreciation.

Charitable contributions of capital assets which would result in long-term capital gain, if sold, are deductible at fair market value, except for the following types of gifts:

(1) Gifts of tangible personal property where the use by the donee is unrelated to its charitable purposes or functions. For example, a gift of a piece of sculpture would be related to the charitable purpose or function of an art museum but not to the function of a symphony society. In other words, if the property is to be sold by the donee to provide funds for the carrying out of its functions, the full fair market value cannot be deducted.

(2) Gifts of any type of property to private foundations which are not operating foundations or to those private foundations which do not distribute all of their contributed receipts within 2½ months after the close of their taxable year. These private foundations which are the exception to the general rule are defined above.

(3) Any other gifts of appreciated property which the taxpayer elects to qualify under the 50 percent maximum rule rather than 30 percent maximum rule.

The amount of the deduction in the case of the above-enumerated cases cannot exceed the taxpayer's basis in the property plus 50 percent of the appreciation or, in the case of corporations, 37½ percent of the appreciation. Section 170(e)(1)(B) states this rule in the opposite manner, providing that the deduction based on fair market value shall be reduced by 50 percent of the appreciation (or in the case of corporations, 62½ percent). The result is the same.

This is going to impact substantially the ability of charitable organizations to raise funds through society auctions and sales of lottery tickets on donated prizes. One of the increasingly popular schemes of fund raising which has evolved from the prior provisions with respect to appreciated property is the society auction. Merchants donate some of their more valuable merchandise because they can contribute to a community-wide fund raising project and, as a result of the favorable tax treatment under the old law, they come out money ahead. In addition, many of the patrons of the charities which were being supported by such auctions would contribute valuable works of art, antiques, and other items of tangible personal property which would be capital assets in their hands provided they were not the creators of such items. The organization which sponsors such an auction is usually exempt from tax under Sec. 501(c)(3) of the Code. The proceeds from the auction are funneled to specific civic organizations such as the symphony, the theater, or the opera. Under the tax reform act, none of the merchandise or assets will qualify for a deduction of full fair market value. Inventory items donated by merchants can be deducted only to the extent of the taxpayer's basis. Even items which are capital assets in the hands of the donors will receive less favorable tax treatment under the new law, because the property will not be related to the charitable purpose or function of the organization to which it is donated. Although the regulations could refute this interpretation, it appears that the object must be used directly by the charitable organization in order to qualify for the more favorable tax treatment. In other words, a painting must be hung in the art museum, not sold to raise funds for the art museum. Under these provisions, the taxpayer-donor is no better off than he would be if he had contributed cash, unless the free advertising he receives during the promotion of the function helps to overcome the less favorable tax consequences.

These provisions are effective for gifts made after December 31, 1969, regardless of the taxable year of the taxpayer. There is one exception to this effective date, and that relates to the donations of letters, memorandum, and similar property made after *July 25, 1969.*

In connection with the exception just noted, it is important to give some consideration to the changes in Sec. 1221(3) of the Code, which defines property which is not a capital asset. This section originally covered copyrights and literary, musical, and artistic compositions which are in the hands of the person whose personal efforts created such property. The Tax Reform Act adds to this definition letters and memorandum which are in the hands of a taxpayer who created them, or in the hands of a taxpayer for whom the property was created or produced. None of the property included under Sec. 1221(3) can be deducted at its fair market value. By definition it is the type of property which, if sold, results in ordinary income. Even though it is related to the exempt purposes or functions of the donee, it will not be eligible for the more favorable treatment because it is not capital gain type tangible personal property.

The problem under the Tax Reform Act is determining if all property described in the above-mentioned section is subject to the July 25, 1969, date or just that property which was added by Act Sec. 514. The Senate Committee originally set the effective date for cutting off this type of gift at December 31, 1968. Their report implies that the early date was to apply only to gifts of letters and memorandum which were the subject of the amendment to Sec. 1221(3). However, the Act itself is worded in such a manner that it might cover gifts of all property included in Sec. 1221(3) as amended. The better view may be that the July 25 date applies only to letters and memorandum which were the subject of Act Section 514. The Conference Committee did not comment on this, so you are referred to Act Sec. 201(g)(1)(B) for your own conclusion.

The reasoning used by the House in originally proposing the limitation on gifts of property of this type is worthy of comment. The Committee reported that these items are very difficult to value and are frequently overvalued for purposes of tax return deduction. If the fair market value is difficult to determine, the taxpayer's basis, when he is the creator of tangible personal property, may be nearly impossible. This provision should effectively end the donation of valuable manuscripts, works of art, letters, and so on to universities, libraries, and museums. It is difficult to imagine a practice so gross that a remedy so devastating is required. Who would have guessed that the world was that full of creative people?

Bargain Sales to Charity

Another ploy used by high-bracket taxpayers owning property which has appreciated in value was the bargain sale to a charitable organization. In this type of transaction, the taxpayer sells the appreciated property to the charitable organization for less than the fair market value (usually his basis) and deducts the difference between the selling price and the value as a charitable contribution. The new law restricts this to some extent but does not eliminate the entire benefit. Under the new law it will be necessary to allocate the tax basis of the property subject to the bargain sale between the portion sold and the portion contributed. This provision is to be implemented by regulations, but under the House Committee report it was contemplated to work as follows. The taxpayer has a capital asset with a tax basis of $12,000, and he sells it to a charitable organization for $12,000. The fair market value is actually $20,000. The ratio of the selling price to the fair market value is 60 percent. Applying this ratio to the tax basis gives the taxpayer an adjusted tax basis of $7,200. The difference between his new basis and the selling price is $4,800 which he reports as a capital gain. He is still able to deduct as a charitable contribution $8,000, the difference between the fair market value and the selling price. This provision, which is included in Sec. 170(e)(2), is effective for sales made after December 19, 1969.

Gifts of the Use of Property

Under the prior law, a taxpayer could donate to a charitable organization the use of a portion of a piece of property, for example, the use of a part of a building. He could then deduct the fair market value of the rental which he would have received had he been renting it to a commercial organization. The effective result of this was to give him a double deduction because he did not have income with respect to this portion of the building, and he was also allowed a deduction for the income he didn't have. The tax reform act takes care of this by denying deductions for contributions after July 31, 1969, of less than an entire interest in the property. Exempted from this provision is a contribution of a remainder interest in a personal residence or farm and a transfer of an undivided interest in a piece of property. The new rules are included in amended Sec. 170(f)(3).

Carryovers

A five-year carryover of contributions in excess of the 50 percent limitation (or 30 percent limitation in the case of capital gain property) is allowed under amended Sec. 170(d). There is no carryover allowed with respect to contributions to private foundations and other organizations which come under the 20 percent limitation. It is therefore very important for the taxpayer to plan his contributions very carefully. Any contributions to a 20 percent type organization will be lost forever if they cannot be deducted in the year of the contribution.